
Swapping our Future: How Students and Taxpayers are Funding Risky UC Borrowing and Wall Street Profits

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Swapping our Future: How Students and Taxpayers are Funding Risky UC Borrowing and Wall Street Profits

**Charlie Eaton, Jacob Habinek, Mukul Kumar, Tamera Lee
Stover, Alex Roehrkas, and Jeremy Thompson**

Preface

On November 13th, 2012, we released “Swapping Our Future” as a contribution to a public sociology grounded in social science but in discussion with a much broader audience. We hoped the report would help solve the problem it critiqued – that a small group of executives and board members tied to Wall Street were making decisions on risky University of California (UC) borrowing with little public participation or even discussion. The unexpectedly strong response, however, gives us new encouragement that public sociology can help empower people beyond the university.

We were first surprised by initial media coverage for “Swapping Our Future.” Press outlets focused on how UC could lose up to \$200 million to Wall Street profits on alleged fraud involving debt instruments called interest rate swaps.

In the week before we issued the report, voters had approved Proposition 30 to raise eight billion dollars a year in new revenue, primarily from taxes on the top one percent of earners. The thought of losing new Proposition 30 funding to Wall Street stoked public outrage. The report recommended that UC recover these losses by either renegotiating its swap agreements or suing.

The initial response from UC executives was dismissive.

California Governor Jerry Brown, however, expressed concern in the UC Regent’s November 14th Finance Committee meeting. Brown’s questions suggested the borrowing was used as capital for an “amenities arms race” in construction of facilities like recreation centers rather than investments in UC’s core mission. Brown asked who, if not tuition and tax payers, would pay for the cost of UC’s debt doubling from seven to 14 billion dollars between 2007 and 2011 alone.

Then, on June 25th 2013, UC made an about turn and filed suit against 20 Wall Street institutions for criminal conspiracy to manipulate an interest rate associated with its interest rate swaps called the London Interbank Offered Rate (LIBOR).

The suit seeks treble damages for funds lost – an award that could total

in the hundreds of millions of dollars or more.

Still, UC's financial decision making remains a relatively closed process involving financial technicians who claim a monopoly on expert knowledge. Members of our research team have a research agenda to explain this closure of governance.

Our first step is a paper titled "Bankers in the Ivory Tower," which we presented at the 2013 Annual Meeting of the American Sociological Association. We have also begun work showing the increasing concentration of profit accumulation from the U.S. economy to the financial sector extends to public higher education institutions. Two of our coauthors have published an initial policy brief showing that interest rate costs for public research universities that grant substantial numbers of PhDs.

We hope that our research agenda will help explain the extent to which the private financial sector accumulates profits from public social programs including higher education. In the meantime, we are honored to have "Swapping Our Future" published in the *Berkeley Journal of Sociology* – a world-class but bottom-up example of public sociology in practice.

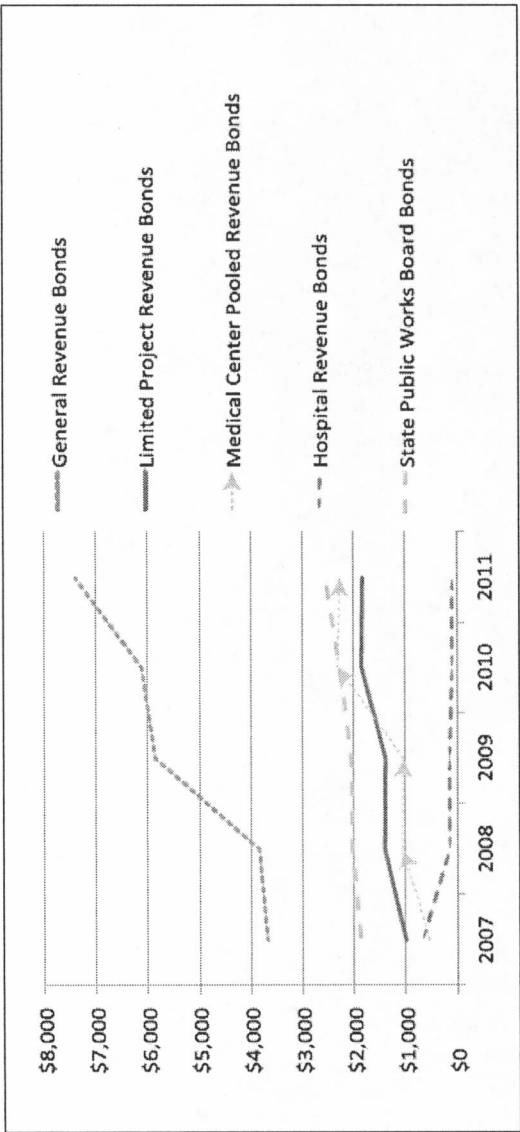
I. Introduction

"We shouldn't be in the banking business, we should be in the education business." – *Leon Botstein, President of Bard College*

Public funding for the University of California has declined drastically. Between 2007 and 2011, annual state funding of UC declined from \$3.8 billion to \$2.2 billion. At the same time, UC Regents and executives have increased borrowing via sophisticated financial instruments. Management has more than doubled the university's debt burden from \$6.9 billion in May 2007 to \$14.3 billion at the end of 2011 (see Figure 1). Although student tuition provides the collateral for much of this borrowing, returns on debt-financed investments have not been used to curb drastic tuition increases, and important sectors of UC remain critically underfunded.

Leaving behind UC's core public education mission, management's investments have been the embrace by the UC Regents and executives of financial derivatives for hedging risk. One such product is the interest rate swap, which has allowed UC to partner with large Wall Street banks over the last decade to issue new types of bonds. While interest rate swaps were thought to guard against some sources of financial risk, they actually increased UC's exposure to the financial crisis. Further, UC's swap agreements have made UC vulnerable to losses following

Figure 1: Total Outstanding UC Debt by Type in Billions, 2007-2011



Source: Office of the Chief Financial Officer, Annual Reports on Debt Capital (2007-2011).

from Federal Reserve interest-rate policies and the illegal manipulation of interest rates by Wall Street. Swaps have already cost UC \$57 million in borrowing costs and could cost as much as \$200 million more over the next 30 years.

In this report we document the costs of UCs swap agreements.

We also show how UC's use of interest rate swap agreements is part of a broader shift in the management of the university. The result of this shift has been the misguided use of risky financial instruments and misplaced trust in Wall Street banks that have cost UC millions of dollars.

Although UC has taken on billions of dollars of new bond debt, students have consistently borne the costs of borrowing while seeing few of its benefits.

The credit rating agency Moody's wrote in September 2012 that UC has a very strong rating as a bond issuer precisely because of it can leverage its "powerful student market position" to "compensate for state funding cuts by raising tuition dramatically" and by "growing non-resident tuition, differentiating tuition by campus or degree, and increasing online course offerings."

UC management is now using its ability to borrow against future tuition increases to engage in some of the same borrowing practices that led to disaster on Wall Street. Without a change in strategy, UC's financial management could compound costs paid by students, workers, and faculty in recent years: tuition hikes, class size increases, limited course offerings, unsafe staffing levels, and uncertainty about funding for a secure retirement (see Table 1). UC management tripled average tuition and fees for undergraduates from \$4,558 in 2002 to \$13,200 in 2012. Low-wage UC workers continue to combat poverty. Faculty and graduate students fear they cannot continue to attract and retain the most qualified colleagues.

Renegotiation of interest rate swaps could save up to \$10 million a year, and approximately \$200 million over the next 30 years. These savings would come at a time when every penny counts for the university. Moreover, redirecting these savings back toward the core mission of the university would be an important step away from borrowing practices that perilously blur the line between profit and public good as the purpose of higher education institutions. Such a step is imperative for a university system with a legacy of world leadership in public education.

II. From Risky Deal to Losing Bet: A Short History of UC's Interest Rate Swaps

The past decade has witnessed a qualitative shift in the financial practices of the University of California. Like many other public institutions, the principal way that UC borrows money from investors is through the issuance of bonds. But whereas UC has relied historically on the State Public Works Board to issue bonds secured by the State of California, beginning in 2003 UC began issuing its own bonds secured

by expected revenues generated by UC projects.

As a part of this new financing strategy, UC managers entered into derivative contracts called interest rate swaps. These swaps promised lower borrowing costs than traditional fixed-rate bonds. Instead, in the wake of the financial crisis interest rate swaps have shackled UC to high annual payments despite record-low interest rates.

Table 1:

Total Issuance of Bond Debt Secured by UC Revenues

- General Revenue Bonds (2003-present): \$8.9 billion.
- Limited Project Revenue Bonds (2004-present): \$2.1 billion.
- Hospital Revenue Bonds (2003-2004): \$352 million.
- Medical Center Pooled Revenue Bonds (2007-present): \$2.3 billion.
- Total Amount of Revenue Bonds Issued, 2003-present: \$13.7 billion.

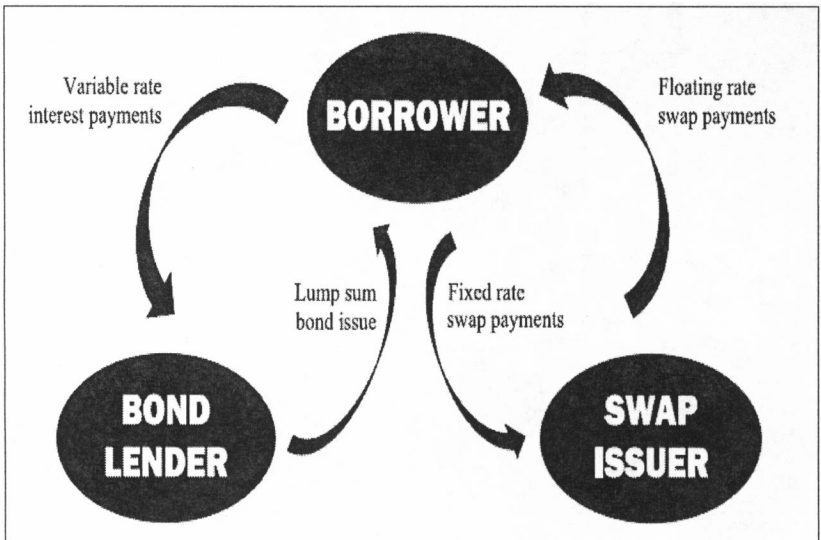
The Human Cost of Cuts to UC's Core Mission

- Tuition nearly tripled from \$4,558 in 2002 to \$13,200 in 2012.
- Enrollment of California residents as a proportion of total freshman enrollment fell by nearly 10% from 2008 to 2011.
- The percent of students from middle income families fell from 50% in 2000 to 40% in 2010.
- New Faculty hires fell from 607 in 2008-09 to under 200 last year.
- Total non-clinical faculty employed declined by 209 from 2009 to 2011.

Interest rate swaps are financial derivatives intended to hedge against a sudden spike in interest payments on a bond or other loan. They act as a form of insurance against interest rate volatility by allowing a bond issuer to convert a variable interest rate into a fixed payment (see figure 2). During the 2000s, many public organizations including UC used interest rate swaps to obtain relatively low, stable payments on variable-rate bond issuances. Between 2003 and 2007, UC entered into three separate agreements involving interest rate swaps with five different investment banks. These swaps were associated with bonds totaling

\$606 million, all funding development at medical centers on three UC campuses (see Table 2).

Figure 2: How Interest Rate Swaps Work



When an organization like UC issues a bond, as with any other loan the interest rates it pays on those bonds may be fixed or variable. Variable interest rates generally represent a cheaper but riskier borrowing option. In order to take advantage of lower variable interest rates while at the same time hedging against the risk of increased interest rates, the borrower may enter into an interest rate swap agreement.

Interest rate swaps are derivative contracts that act as a form of insurance against fluctuating interest rates. The borrower agrees to pay a fixed rate of payment to another party — often an investment bank — who in return pays the borrower a variable rate based on the rate of the original bond. The coupling of variable-rate bonds with interest rate swaps offers a lower rate of payment than a traditional fixed-rate bond. In this way, the borrower is protected against increases in interest rates. However, the swap constitutes a separate financial agreement — essentially an ongoing bet on interest rates — between the borrower and the swap counterparty. This agreement usually includes substantial termination costs, making refinancing prohibitively costly.

Table 2: Interest Rate Swap Agreements Initiated by the University of California, 2003-2008

Swap	Dates	Bond Broker	Swap Counter-party	Notional Value	Fixed Rate (UC to issuer)	Current Rate (issuer to UC)	Projected Annual Loss	Loss to Date
UCD Medical Center	2003-2008 (terminated)	Merrill Lynch	Merrill Lynch	\$174m	3.1385%	N/A	N/A	\$22.5m
		JPMorgan Chase	JPMorgan Chase	\$87m	3.1385%	N/A	N/A	
		Goldman Sachs	Goldman Sachs	\$87m	3.1385%	N/A	N/A	
UCSF Medical Center	2007-2032	Merrill Lynch	Merrill Lynch (until 2009), BofA (since 2009)	\$83m	3.5897%	2.982%	\$2.5m	\$11m
UCLA Medical Center	2007-2047	Lehman Brothers	Lehman Brothers (until 2008), Deutsche Bank (since 2008)	\$175m	4.6873%	3.723%	\$6.5m	\$23m

Sources: University of California Medical Center Pooled Revenue Bonds, 2007 Series A, B and C, Official Statements; University of California Annual Financial Report, 2010-2011; University of California-Davis Medical Center Refunding Hospital Revenue Bonds, 2003 Series A-E, Official Statements; University of California General Revenue Bonds, 2011 Series Y, Z and AA, Official Statement.

UC's decision to enter into these agreements was part of a broader shift in the way UC manages its finances, from project-by-project funding to a comprehensive strategy for maximizing UC's utilization of debt financing. As early as fall 2002 the UC Office of the President solicited an analysis from Lehman Brothers, which led to the adoption of a new system of bond issuance secured by the broadest possible range of UC revenue sources.¹ In 2006, the UC Office of the President reorganized its leadership structure, creating the new roles of Chief Financial Officer and Executive Vice President for Business Operations and recruiting former Wall Street executives to fill those positions.² At a January 2007 meeting of the financial committee of the UC Regents, Regents' concerns that "UC's approach to debt management was overly conservative" and that "the allocation of debt capacity [had] not been in agreement with UC's strategic priorities" led them once again to retain Lehman Brothers to develop options for expanding UC's debt load.³

Exactly how and why UC decided to purchase its interest rate swaps on bonds secured by medical center revenues is unclear. Despite requests by the authors of this report, UC management has not provided documentation for the original swap agreements. Some of these swaps have been replaced by new agreements following the bankruptcy or acquisition of swap counterparties like Lehman Brothers and Merrill Lynch.

What is clear is that over this period, big banks marketed interest rates swaps to public organizations like UC as a safe way to borrow more money less expensively.⁴ In reality these swaps created new costs for

1 Ibid.

2 The ambiguity surrounding these new roles caused concern among UC's academic leadership (c.f. UC Academic Council Minutes. June 21, 2006). The financial leadership of UC before the hiring of these officers in 2009 remains even more opaque.

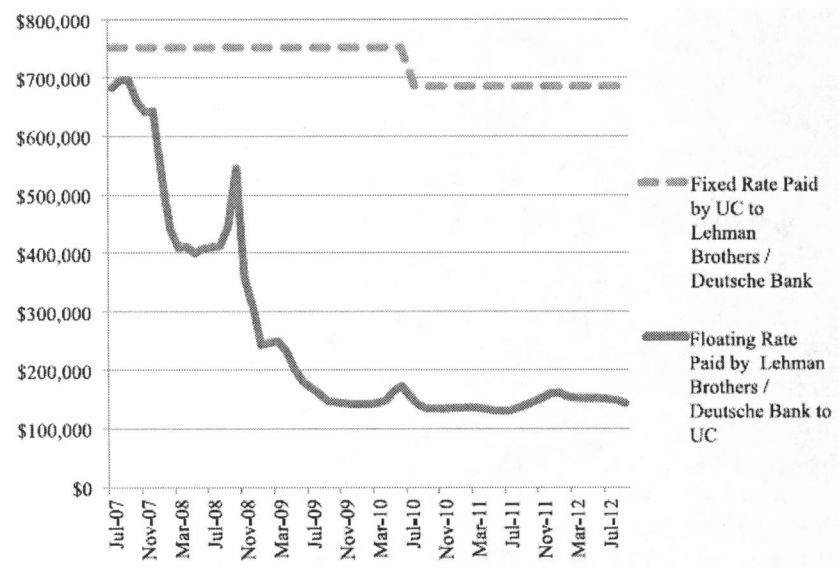
3 The Regents of the University of California. Committee on Finance. January 18th, 2007. <http://regents.universityofcalifornia.edu/minutes/2007/fin17.pdf>

4 Darrell Preston. "Governments using swaps to emulate subprime victims of Wall Street." *Bloomberg*. November 13th, 2011. <http://www.bloomberg.com/news/2011-11-14/governments-using-swaps-emulate-subprime-victims-of-wall-street.html>

borrowers when interest rates decline significantly, as they did beginning in late 2007 (see Figure 3). While swaps do insure their holders against general volatility in interest rates, most also have steep termination fees that discourage borrowers from capitalizing on lower market interest rates by refinancing the underlying loans at a new rate. In other words, interest rate swaps were not safe deals, but rather bets on future market conditions.

Rather than safeguarding UC’s fiscal future, these bets have proven to be losers for UC. Because of swap agreements, UC has missed out on refinancing opportunities, instead continuing to pay high fixed rates. Ironically, rock-bottom interest rates have greatly increased UC’s relative debt servicing burden despite the fact that the cost of new borrowing remains at record lows. Losses on the swaps associated with the UC Davis medical center were so significant that UC paid \$6.8 million in termination fees when it refinanced the underlying bonds. The swaps associated with medical centers at UCSF and UCLA are projected to create combined annual losses of \$9 million. The projected total loss from UC’s engagement in interest rate swaps is more than \$200 million.

Figure 3: Monthly swap payments for 2007 UCLA Medical Center Bonds



Sources: University of California Medical Center Pooled Revenue Bonds, 2007 Series C, Official Statement, Libor three month floating rate.

The interest rate declines that inflated UC's relative borrowing costs were the product of fundamental changes in the rules of the game that many institutional borrowers did not expect before the financial crisis. First was the move by the Federal Reserve to push interest rates to record lows in order to stabilize large banks and stimulate economic recovery. Between September 2007 and December 2008, the Fed implemented a series of cuts that saw the effective federal funds rate drop from 5.25% to 0-0.25%. Recently, Fed Chairman Ben Bernanke has restated his commitment to keeping interest rates at comparable lows for the foreseeable future.

The second factor that drove down interest rates and increased UCs borrowing costs was the illegal efforts by major banks to manipulate London Interbank Offered Rate (LIBOR), which indexes interest rates on most bonds issued by UC. As interest rates began to plummet in late 2007, the investment banks brokering UC's bond issues continued to market and sell swaps to borrowers. By 2008 many of the banks had run up enough risky loans on their own balance sheets to push the global economy to the brink of collapse. Under these conditions, major banks engaged in illegal efforts to manipulate LIBOR. These manipulations may have exacerbated UC's losses, and each of UC's swap counterparties is under investigation for LIBOR manipulation.

The financial crisis and its responses have had clear effects on the costs of UC's swap agreements. Unprecedentedly low interest rates mean that UC's swap payments have ballooned relative to current market rates. As long as interest rates remain low, UC will continue to pay investment banks millions of dollars a year through its swaps. As such, the financial crisis changed the "rules of the game": while banks received critical public assistance in meeting their debt obligations, public organizations like UC remain on the hook.

III. RESPONDING TO DERIVATIVE DISASTERS

A range of public institutions—including states, cities, universities, museums, transit authorities, hospitals and pension funds—are among the principal victims of toxic interest rate swaps and LIBOR rate manipulation. By 2010, taxpayers paid a total of \$4 billion to terminate interest rate swap deals with Wall Street banks.⁵ It is estimated that total government losses on LIBOR rate manipulation could total another \$1

5 Michael McDonald. "Wall Street Collects \$4 billion From Taxpayers as Swaps Backfire." *Bloomberg*. November 9th, 2010. <http://www.bloomberg.com/news/2010-11-10/wall-street-collects-4-billion-from-taxpayers-as-swaps-back-fire.html>

billion.⁶ Given record-low interest rates and the “new rules of the game” outlined above, public institutions face an important choice: Will they accept additional taxpayer losses and pay exorbitant swap termination fees to Wall Street? Or will they hold banks accountable to taxpayers by renegotiating their agreements and pursuing LIBOR litigation?

Derivative Disasters

From Jefferson County, Alabama to Harvard University, there is a long list of derivatives disasters across the US. California’s Water Resources Board spent \$305 million terminating interest rate swaps with a group of banks led by Morgan Stanley. North Carolina paid \$59.8 million to terminate its swaps agreements, enough to pay annual salaries for 1,400 employees.⁷ The city of Reading, Pennsylvania paid \$21 million on its interest rate swaps, the equivalent of more than a year of real estate taxes.⁸ Meanwhile, Jefferson County, Alabama, was driven to bankruptcy—the largest of its kind in US history—as a result of its interest rate swaps (in the process, 1,000 employees, or one quarter of the county’s workforce, had to take unpaid administrative leave).⁹

Both public and private universities have paid a significant price for their risky bets. The most notorious case is Harvard University, which paid almost \$1 billion to terminate its interest rate swaps negotiated under the tenure of the university’s former president, Larry Summers.¹⁰ In response, one former Dean of Harvard College stated: “There’s something systematically wrong with Harvard Corp. It’s too small, too secretive, too closed and not supported by enough eyeballs looking at the risks they’re taking.”¹¹ In Tennessee, Vanderbilt University paid \$87.2 million to back out of its deals.¹² And, as discussed above, the University of California terminated one of its swaps with total losses (including termination fees) totaling \$22.5 million.

6 Darrell Preston. “Rigged LIBOR Hits States, Localities with \$6 billion,” October 8th, 2012. *Bloomberg*. <http://www.bloomberg.com/news/2012-10-09/rigged-libor-hits-states-localities-with-6-billion-muni-credit.html>

7 Michael McDonald, op. cit. (n. 23).

8 Ibid.

9 Matt Sherman and Nathan Lane. “Cut Loose: State and Local Layoffs of Public Employees in the Current Recession,” *Center for Economic and Policy Research*. September 2009.

10 Michael McDonald, John Lauerma, and Gillian Wee. “Harvard Swaps are So Toxic Even Summers Won’t Explain.” *Bloomberg*. December 18th, 2009.

11 Ibid.

12 Brian Riesiger. “Vanderbilt University Caught by Interest Rate Swap.” *Nashville Business Journal*. November 19, 2010. <http://www.bizjournals.com/nashville/print-edition/2010/11/19/vanderbilt-caught-by-rate-swap.html>

Alternatives: Swap Renegotiation and LIBOR Litigation

The University of California, however, does not have to be yet another victim of toxic swaps. It can join a growing number of public institutions that are demanding to renegotiate their swap agreements, especially in light of the LIBOR scandal. The San Francisco Asian Art Museum successfully terminated its swaps without penalties, saving the museum \$40 million, and the City of Richmond renegotiated its swaps, saving taxpayers \$5 million a year.¹³ The City of Detroit also reduced its swap obligations and is saving \$25 million a year (although it continues to lose \$54 million a year on other swaps).¹⁴ In addition, Peralta Community College recently filed suit against JPMorgan over its interest rate swap deals.¹⁵ The City Councils of both Oakland and Los Angeles have voted unanimously to terminate or renegotiate their interest rate swap agreements with Goldman Sachs and Bank of New York Mellon, respectively.¹⁶

Since most interest rate swaps are tied to LIBOR, dozens of states, cities and other public institutions are investigating the effects of LIBOR rate manipulation on interest rate swaps, including at least five attorneys general.¹⁷ The City of Baltimore and New Britain's Firefighters Benefit Fund, a pension fund for the Connecticut city, have already filed suit against several banks for LIBOR manipulation.¹⁸ In California, the Public Employees Retirement System (CalPERS) and San Francisco's Bay Area Metropolitan Transit Commission are investigating the impacts of LIBOR manipulation on their swaps.¹⁹

13 For Richmond, see City of Richmond, "Comprehensive Annual Financial Report for the Year Ended June 30, 2010," pp. 79-83, and City of Richmond, "Report for the Year Ended June 30, 2009, p. 85. For the Asian Art Museum of San Francisco, see "Mayor Newsom, City Attorney Herrera, City Controller Ben Rosenfield, President Chiu and Asian Art Museum Foundation Announce Proposal to Restructure Foundation's Debt. January 6, 2011; and Reyhan Marnanci, "Asian Art Museum Avoids Bankruptcy" (*The Bay Citizen*. January 6th, 2011. <http://www.baycitizen.org/blogs/pulse-of-the-bay/asian-art-museum-avoids-bankruptcy/>).

14 City of Detroit. "Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2011." p. 113.

15 Sarah McBride. "California college district sues JP Morgan over financing deal." Reuters. August 13th, 2012.

16 For Los Angeles, see David Zahniser, "LA wants to quit or alter two bank deals" (*Los Angeles Times*. March 10th, 2010. <http://articles.latimes.com/2010/mar/10/local/la-me-rate-swaps10-2010mar10>). For Oakland, see Tracy Alloway and Nicole Bullock, "Oakland Council Tackles Swap Deals" (*Financial Times*. August 2nd, 2012).

17 David McLaughlin. "LIBOR Manipulation Probed by 5 State Legal Offices." *Bloomberg*. July 17th, 2012. <http://www.bloomberg.com/news/2012-07-16/libor-manipulation-investigated-by-new-york-connecticut.html>

18 Ibid.

19 Ibid.

All of the banks that have contracted as counterparties for UC's swap agreements are under investigation for LIBOR rate manipulation. Barclays Capital, which was tied to the UCLA swap through its partnership with Lehman Brothers, was the first major investment bank to be charged and fined by British authorities.²⁰ Deutsche Bank, which took over the swap after Lehman went bankrupt, has also admitted complicity in LIBOR manipulation.²¹ Bank of America, counterparty to the UCSF swap, has been subpoenaed by investigators in New York, as has JP Morgan, the counterparty to the now-terminated UC Davis swap.

The UC swaps covered in our report were all outstanding for at least some portion of the Class Period in the Baltimore suit. (The UC-Davis Medical Center swaps were terminated about a quarter of the way through the Class Period of August 2007 through May 2010.) The total notional value of UC's swaps during the Class Period was about \$360 million. Based on a -29 bps spread and each swap's LIBOR factor, we estimate that UC paid banks about \$1.92 million more than it should have absent the alleged manipulation of LIBOR.²² Baltimore is suing under federal antitrust statutes and seeking treble damages. Treble damages for UC, based on the \$1.92 million estimate, would be \$5.76 million.

It remains to be seen whether UC's Regents will join public institutions across the country that are holding banks accountable for toxic swap deals and LIBOR rate manipulation—or if the university will become yet another derivative disaster.

IV. WHY HASN'T UC MANAGEMENT RENEGOTIATED?

Despite inquiries from the authors, as of the printing of this report UC executives have provided no explanation for their inaction when it comes to renegotiating interest rate swaps. Management has justified medical center and capital projects borrowing in the past by arguing that students and taxpayers would neither bear the costs of borrowing nor benefit from forgoing the borrowing. According to this premise, savings from reduced borrowing costs should not be passed onto students. This premise, however, is false: the Regents have consistently borrowed against public assets and are now also pledging to use future tuition and fee increases to pay off medical center debt.²³ It follows that savings

20 Jill Treanor. "Barclays: from Libor to PPI, the charges in full." *The Guardian*. October 31, 2012

21 "Libor scandal: Deutsche Bank admits some staff involved." *BBC News*. July 31, 2012: <http://www.bbc.co.uk/news/business-19066284>

22 The floating swap payment received is generally based on percent of LIBOR.

23 University of California Report on Audit of Financial Statements and on Federal Awards Programs in Accordance with OMB Circular A-133 For the Year Ended June 30, 2011." p. 2. <http://www.ucop.edu/capmarketsfin/documents/>

Table 3: Savings and Costs of Swap Exit Strategies

Institution	Year	Strategy	Results
UC Davis Medical Center Swap	2008	Termination Fee	UC paid \$6.8 million to terminate its swaps with JPMorgan Chase, Goldman Sachs and Bank of America, bringing its total losses on these swaps to \$22.5 million
Harvard University	2008	Termination Fee	Almost \$1 billion in termination fees to several banks, including Goldman Sachs and JPMorgan
Vanderbilt University	2010	Termination Fee	Vanderbilt paid a \$87.2 million termination fees to several undisclosed institutions
California Water Resources Board	2012	Termination Fee	The CA Water Resources Board paid \$47.2 million in termination fees to JPMorgan Chase, Deutsche Bank, Citigroup and Morgan Stanley
City of Richmond, CA	2010	Renegotiation	Renegotiation with Royal Bank of Canada saves Richmond \$5 million annually
San Francisco Asian Art Museum	2011	Renegotiation	JPMorgan cancels \$21 million in swaps and returns \$13 million in collateral to the museum. Issues new bonds at a fixed rate of 4.6%
City of Baltimore, MD	2012	Pursing LIBOR litigation	Seeking damages on \$550 million of bonds. The suit names JPMorgan Chase, Bank of America, Barclays, Citibank and Deutsche Bank
Peralta Community College District	2012	Pursuing litigation	Filed suit against JPMorgan Chase alleging violation of the CA State Constitution on swaps currently valued at \$3.4 million

Source: See Supra Notes 25-35

resulting from swap renegotiation can and should be passed on to UC students and employees. Banks have argued against renegotiation, claiming that borrowers are bound by contract to honor these disadvantageous agreements. After the 2008 financial crisis changed the rules of the game, however, examples such as the San Francisco Asian Art Museum and City of Richmond clearly demonstrate that it is both possible and

desirable to renegotiate swaps.²⁴ So why has UC not at least attempted to renegotiate with its counterparties, Bank of America and Deutsche Bank

UC Management's Revolving Door with Wall Street

Wall Street has markedly increased its foothold in the management of the University of California over the last 25 years. This trend has accelerated since a core of UC Regents with ties to Wall Street selected Mark Yudof as UC's new President in June 2008. In 1990, none of UC's top management or Regents had worked for or served on the board of a major Wall Street bank.²⁵ Today, current and former business and finance executives play a prominent role on the Board of Regents (see Figure 4).

UC administration has also been restructured to reflect the growing influence of Wall Street. Central to the restructuring was the creation of a new Chief Financial Officer (CFO) position in 2009. The CFO has been responsible for the oversight of new efforts to increase UC's borrowing. The Regents created the position with support from Wells Fargo Senior Vice President Russell Gould, who chaired the Regents' Finance Committee at the time.²⁶ Gould had been Executive Vice-President of Wachovia Bank until the Federal Deposit Insurance Commission (FDIC) brokered Wachovia's bailout and acquisition by Wells Fargo.²⁷ Wachovia had been on the verge of bankruptcy because of aggressive borrowing practices and overexposure to the market for mortgage backed securities.

To fill the new CFO position, the Regents hired Peter Taylor, who had just lost his job as Managing Director of Public Finance for Lehman Brothers/Barclays Capital after Lehman Brothers collapsed in 2008. These agencies have argued that swap renegotiation is appropriate for reasons we described earlier – the rules of the game changed with the 2008 financial crisis after the UCLA and UCSF swap contracts were signed. Nobody expected that the Federal Reserve would bail out Wall Street with nearly free credit for several years. And nobody thought that the big banks would manipulate Libor, increasing losses for UC and other non-profit and municipal swap purchasers. The Fed intended for near zero interest rates to make borrowing cheaper for UC. Instead, because of our derivative contracts, Wall Street is netting larger profits. One might argue that UC is a weaker position than the Asian Art Museum or the City of Richmond for renegotiating because we have no risk of bankruptcy, in which case a bankruptcy court could invalidate our derivative contracts. The Peralta Community College district, however, has brought Morgan Stanley to the negotiating table with no risk of bankruptcy. Morgan Stanley entered negotiations quickly with Peralta, expressing concern about possible damage to the bank's image from public complaints about course reductions made to fund derivative payments.

25 Charles Schwartz. "A Look at the Regents of the University of California." <http://socrates.berkeley.edu/~schwartz/LOOKatREGENTS.pdf>

26 "Russell Gould elected Board of Regents' chairman." *UC Newsroom*. May 7th, 2009. <http://www.universityofcalifornia.edu/news/article/21127>

27 Eric Dash and Ben White. "Wells Fargo Swoops In." *The New York Times*. October 4th, 2008. <http://www.nytimes.com/2008/10/04/business/04bank.html>

the largest bankruptcy in US history.²⁸ Taylor's position at Lehman gave him authority for the bank's sales of financial products to UC. During that period, Taylor also served on multiple governing bodies of the university, including as a Regent, as vice chair of the Regents' finance committee, and as President, Chair, and member of the UCLA Foundation board of directors.²⁹

Also in 2009, another Wall Street veteran rose to one of UC's top five management positions: bank executive Nathan Brostrom became the Executive Vice President for Business Services.³⁰ Brostrom had worked for two years in a similar position at UC Berkeley, but before that had spent nearly two decades working on Wall Street, including ten years at JP Morgan Chase. Prior to leaving JP Morgan in 2006, Brostrom became the company's top executive for its Western Region Public Finance Group. Like Taylor's position at Lehman, this position gave Brostrom authority over sales of financial products to UC.

Risky Debt and Profits Above All: The Wall Street Strategy for the Budget Crisis

In the face of state funding reductions, the UC Regents, aided by their new executives, dramatically expanded borrowing between 2007 and 2011. Rather than offset cuts, management used much of the borrowing to invest in areas outside of UC's core mission that were seen as potentially more profitable.

Management has used much of UC's expanded borrowing to invest in the expansion of two for-profit activities outside of UC's core mission. First, it has used the borrowing to invest in medical center expansions intended to grow medical center profits. Second, it has also used borrowing to invest in new housing and dining facilities at a time when overall enrollment has declined by 7% per year. The new facilities, however, have helped to accommodate growing out-of-state enrollment.³¹ Out-of-state enrollment across the UC system doubled from 6% to 12% and tripled at UC Berkeley from 11% to 30% between 2009 and 2011.³²

28 Sam Mamudi. "Lehman folds with record \$613 billion debt." *Marketwatch*. September 15th, 2008. <http://www.marketwatch.com/story/lehman-folds-with-record-613-billion-debt?siteid=rss>

29 "Board of Directors." <https://www.uclafoundation.org/aboutus.aspx?content=directors>

30 "Nathan E. Brostrom appointed UC executive VP for business operations." *UC Newsroom*. January 21st, 2010. <http://www.universityofcalifornia.edu/news/article/22707>

31 Hans Johnson. *Defunding Higher Education: What Are the Effects on College Enrollment?* Public Policy Institute of California. San Francisco. 2012. http://www.ppic.org/content/pubs/report/R_512HJR.pdf

32 Kevin Yamamura. "UC Looks Beyond California." *Sacramento Bee*. Thursday,

Moody's has noted that there are some risks involved with this investment strategy because political backlash may limit growth in out-of-state enrollment.

As of 2011, UC has developed protocol for purchasing, modifying, and terminating swap agreements as a tool for this expanded borrowing. The protocol gives significant discretion to Taylor as CFO.³³ This new protocol acknowledges that swaps "are derivative transactions and are not without risks."³⁴ But UC management has not provided records showing evidence of an official interest rate swap protocol before 2011, nor has management provided requested documents showing how swap decisions were made or by whom.

Moreover, at the time this report went to print UC executives had provided no explanation for why they have not sought to renegotiate UC's swap agreements. But similar cases of complacency in other organizations offer instructive examples. Executives with the Metropolitan Transit Authority in New York – where Vice President Brostrom's predecessor served as CEO³⁵ – explained their hesitance to negotiate aggressively with their investment bank counterparties:

It would be "bad business practices" to think of suggesting that the Authority would not place new bonds with a bank unless it agreed to re-negotiate existing agreements.³⁶

However, an independent arbitration panel for the State of New York Public Employment Relations Board countered such logic in a ruling related to the MTA's interest rate swaps: "Such renegotiations may not be successful, but it is more than difficult to understand why the Authority is of the opinion that it should not even try."³⁷ Why do UC administrators seem to be of this same opinion?

Conflicts of Interest?

UC's outstanding swap agreements are held by banks with close ties to UC executives and Regents. Further, both swap agreements were sold to UC by banks that at the time employed public finance executives

May. 3, 2012. Page 1A:

<http://www.sacbee.com/2012/05/03/4461864/uc-looks-beyond-california-to.html>

33 UC Regents Committee on Finance. "AUTHORIZATION TO APPROVE INTEREST RATE SWAP GUIDELINES." July 13, 2011. <http://regents.universityofcalifornia.edu/regmeet/jul11/f3b.pdf>

34 Ibid.

35 "Former New York transportation chief named UC executive vice president for business operations." UC Office of the President. Thursday, March 15, 2007: <http://www.universityofcalifornia.edu/news/2007/mar15a.html>

36 State of New York Public Employment Relations Board (PERB Case No. TIA2011-010) Opinion and Award. p. 19.

37 Ibid. p. 31.

who now serve among UC's top five executives. Unless these relationships are clearly understood, UC decision-making processes about borrowing and renegotiating are not sufficiently transparent and accountable to UC stakeholders.

The UCLA medical center swap – which has already cost UC \$23 million – was sold to UC in 2007 by Lehman's/Barclays during UC CFO Peter Taylor's tenure with that firm. At the time, Taylor also served on the board of the UCLA Foundation where he concluded his term as Board Chair just two years earlier. While Deutsche Bank took over the swap after the collapse of Lehman's, Taylor's ties to the swap's origination raise questions about what consideration has been given to renegotiation. This swap also deserves attention because Lehman's served both as the broker for the bond and the counterparty for the swap – a practice that was not allowed for mortgage derivatives until deregulation under the Glass-Steagall Act of 1999.

The UCSF medical center swap was sold to UC in 2007 by Merrill Lynch,³⁸ which has since been acquired by Bank of America, on whose board Regent Monica Lozano serves. Executive Vice President Brostrom also worked for Merrill Lynch prior to his time at JP Morgan. The terminated swap for UC Davis, was sold to UC by JP Morgan when Executive Vice President Brostrom managed JP Morgan's Western Region Public Finance Group.³⁹ Just as Lehman did with the UCLA medical center swap, JP Morgan profited both on the sale of the original bond and on the sale of the related swap agreement to UC – a practice not allowed in other areas of derivative financing.

V. RECOMMENDATIONS

Based on our findings, we offer recommendations in two areas: the renegotiation of interest rate swaps, and the governance and practices of UC's overall borrowing program in which interest rate swaps have played an important role.

Interest Rate Swap Recommendations

UC should seek to renegotiate its existing interest rate swaps with Bank of America and Deutsche Bank. Renegotiation of these swaps could save up to \$200 million and fulfill the intended purpose of the Federal Reserve's near-zero interest rates – supply of low-cost lending to job- and innovation-creators like the University of California.

38 University of California Medical Center Pooled Revenue Bonds, 2007 Series A and B, Official Statement.

39 University of California-Davis Medical Center Refunding Hospital Revenue Bonds, 2003 Series A-E, Official Statement, p. 3.

UC should review the lawsuit filed by Peralta Community College District against JPMorgan Chase and evaluate its options for legal action against its swap counterparties.

UC should evaluate its legal options with respect to the manipulation of LIBOR. Deutsche Bank has admitted involvement of its staff in the fraud.⁴⁰ Bank of America has been subpoenaed, as well.⁴¹

Borrowing Policy and Governance Recommendations

A body composed of delegates from key UC communities – including persons from independent student organizations, faculty organizations, employee unions, and parents – should conduct a comprehensive review of UC borrowing practices. Key issues for consideration include: What risk exposure has been created for taxpayers, tuition payers, students, and employees by the doubling of UC's debt burden since 2007? How much of UC's increased borrowing has been undertaken to fulfill UC's core mission? How much of UC's increased borrowing has been used for investing in areas outside of UC's core mission such as profitable medical services and out-of-state enrollment? Have profits from investments financed by UC borrowing been returned to underfunded programs for fulfilling UC's core mission? Or are profits being reinvested leading to a "mission creep"? Have conflicts of interest involving UC Regents, executives, or donors influenced borrowing decisions including decisions on UC's interest rate swaps?

A similar body should conduct a review of UC governance of borrowing practices. Key issues for consideration could include: To what extent are the UC Regents promising fees as collateral for debt unrelated to its core mission? To what extent were all campus constituencies involved in deliberation and a concerted decision to double UC's debt burden since 2007? What expertise is needed for making borrowing policy and decisions other than that provided by executives and Regent's with close ties to Wall Street? How could student organizations, employee unions, faculty, and the state contribute needed expertise? How could all stakeholders – students, faculty, workers, tuition payers, alumnae, tax payers – be equitably involved in governance of UC borrowing practices?

The costs of UC's interest rate swaps provide a warning about the risks of adopting debt-driven profit strategies and tactics used on Wall

40 "Libor scandal: Deutsche Bank admits some staff involved." *BBC News*. July 31, 2012: <http://www.bbc.co.uk/news/business-19066284>

41 Reed Albergotti and Jean Eaglesham. "9 More Banks Subpoenaed Over Libor." October 25, 2012: <http://online.wsj.com/article/SB10001424052970203897404578079413742864842.html>

Street. UC still has an opportunity to renegotiate and save precious dollars for reversing devastating tuition hikes and cuts. But swift action and involvement by the entire UC community may be necessary. Further, UC-wide involvement in an overhaul of UC's policies, practices, and governance of borrowing could be a necessary step towards reversing cuts and tuition hikes.

Appendix

UC's **current annual losses** on interest rate swaps are calculated as follows:

Subtract the fixed interest rate, paid by UC to the swap counterparties, from the variable interest rate, received by UC from the swap counterparties, to arrive at the net interest rate.

[Net interest rate] = [Variable rate received] - [Fixed rate paid] Multiply the notional value of the swap by that difference.

[Swap loss] = ([Notional value] x [Net interest rate])

We can use the UCLA Medical Center swap as an example. The notional value of this swap is \$174,775,000. Under the swap, UC pays its counterparty, Deutsche Bank, a fixed rate of 4.6873% and receives a variable rate equal to 67% of three-month LIBOR plus 73 basis points.⁴² With three-month LIBOR at 0.35%⁴³, the variable rate received is 0.9645%.

[Net interest rate] = 0.9645% - 4.6873% = -3.7228%.

[Swap loss] = (\$174,775,000 x -3.7228%) = **-\$6,506,524**

At current interest rates, UC is losing about \$6.5 million to Deutsche Bank annually. The calculation of **losses to date** is largely the same. There are a handful of additional factors to keep in mind, though: Changes in the notional value of the swap. Often the notional value of the swap will decrease each year (to track decreases in the principal outstanding on the associated bond). For example, whereas the notional value of the UCLA Medical Center swap was \$174,775,000 as of the end of FY2011, it was \$189,775,000 as of the end of FY2010.

Changes in LIBOR. As LIBOR goes up and down, the variable rate received by UC changes. When the variable rate exceeds the fixed rate, UC receives a net payment from the bank counterparty, and when

⁴² University of California Annual Financial Report, 2010-2011, p. 70.

⁴³ Rate as of 3 October 2012, from <http://www.bankrate.com/rates/interest-rates/libor.aspx>, accessed 9 October 2012.

the fixed rate exceeds the variable rate, as it has for several years now, UC makes a net payment to the bank.⁴⁴

Sometimes swap deals involve premiums and termination charges. For the UCLA Medical Center swap, the sum of net swap losses from July 2007 through September 2012 total \$29 million. But when UC replaced the original counterparty, Lehman Brothers, after its bankruptcy, with Deutsche Bank, it received an upfront payment of \$31 million from Deutsche Bank. UC also paid a \$25.3 million termination payment to Lehman.⁴⁵ When the net gain of \$5.7 million is subtracted from the \$29 million loss, the actual total losses through September 2012 are about \$23 million. There were no premiums associated with the UCSF Medical Center swap.

Projected losses are based on figures reported in UC's FY2011 financial statements. The statements report projected net swap payments, based on the schedule of future notional values and variable rates in effect on the statement date – 30 June 2011, in the case of the FY2011 statements. Because we calculate swap payments from July 2011 through September 2012, we subtract these payments from the projected payments listed in UC's FY2011 financial statements. Sticking with the UCLA Medical Center swap, the medical center's FY2011 financial statement lists future net swap payments of \$177,769,000.⁴⁶ Using the calculation laid out in section A of this Appendix, we calculate net payments from July 2011 through September 2012 of \$8,006,922. Taking these net payments from the projected amount listed in the financial statement, the remainder is \$169,762,078.

44 Historical LIBOR rates from http://www.fedprimerate.com/libor/libor_rates_history.htm.

45 University of California Annual Financial Report, 2008-2009, p. 96.

46 UCLA Medical Center Annual Financial Report, 2011, p. 40.

